BEFORE THE
STATE CORPORATION COMMISSION
COMMONWEALTH OF VIRGINIA

COMMONWEALTH OF VIRGINIA, ex rel.

STATE CORPORATION COMMISSION **CASE NO. PUE-2004-00068**

Ex Parte: In the matter of establishing rules and regulations pursuant to the Virginia Electric Utility Restructuring Act for exemptions to minimum stay requirements and wires charges

RESPONSE OF DELMARVA POWER & LIGHT COMPANY TO QUESTIONS POSED IN ORDER ESTABLISHING PROCEEDING

NOW COMES Delmarva Power & Light Company (Delmarva), by counsel, and responds to questions posed by the Commission in its June 16, 2004 Order Establishing Proceeding in the above captioned case. Delmarva also hereby informs the Commission of its intent to participate in the work group described in that Order.

This proceeding focuses on statutory exemptions from "minimum stay" provisions and "wires charges" under amendments to the Virginia Electric Utility Restructuring Act set forth in Va. Code § 56-577.E.2 and § 56-583.E that went into effect July 1, 2004. The purpose of these amendments to the Act is to facilitate the development of retail electric competition in Virginia by making it easier for large commercial and industrial customers to switch their service between an incumbent electric utility and competitive service providers.

Such customers who return to service by the incumbent utility had been subject to a requirement to remain a customer of that utility for a minimum of one year after their return. These amendments create an alternative to the minimum stay requirement for these customers, *i.e.* agreeing to be served on "market-based" rates instead of capped rates. These amendments, therefore, make it necessary to determine how "market-based" rates will be set so that they can be made available to such returning customers. Indeed, new Va. Code § 56-577.E.4 requires the Commission to promulgate rules and regulations necessary to implement the new minimum stay exemption program.

Delmarva has experience in the determination of market-cost based rates. Since July 1, 2004 all of Delmarva's Maryland electric retail customers have been served on such rates. Those customers, of course, also have the choice of purchasing electric energy from competitive suppliers instead of Delmarva. Based on its experience in its Maryland jurisdiction and other retail service jurisdictions, Delmarva will respond specifically to Questions 4, 5, 6 and 7 which focus particularly on "market-based costs" of electric energy.

4. Describe, in reasonable detail, the methodology that should be used to determine "market-based costs"' Such description should address each of the three cost components: "(i) actual expenses of procuring such electric energy from the market, (ii) additional administrative and transaction costs associated with procuring such energy, including, but not limited to, costs of transmission line losses, and ancillary services, and (iii) a reasonable margin." Specifically, for each component, identify (1) each cost item that should be considered within that component; (2) how each such cost item should be determined, including the informational source of any data needed in such determination (differentiate between actual and estimated costs and also, to the extent relevant, differentiate between incremental cost and fully allocated cost, including the application of cost overheads); and (3) an explanation of the economic rationale for the determination of a reasonable margin.

RESPONSE:

4. (i) Delmarva is a member of PJM and is able to purchase in the PJM markets all of the energy, capacity and necessary ancillary services for its provider of last result (POLR), or default service, load . The PJM Independent System Operator (ISO) operates spot markets for these services. Market participants also can and do engage in bilateral contracts for forward contracts around the liquid, stable PJM spot markets. Delmarva could use either or both of these

alternatives to procure supply for customers who return to Delmarva from competitive retail providers.

Where the procurement is for longer term service for the majority of its load, Delmarva prefers to use a competitive "Request for Proposals" (RFP) process. Delmarva has successfully used this form of procurement in its Maryland service territory. Delmarva also uses purchases from PJM spot markets where the loads are variable and relatively small; for example, to serve customers who receive "Hourly Priced Service" in Maryland. Market prices are obtained in either case, with the pricing suited to the nature of the service.

In Maryland, the RFP process has attracted many suppliers, and much more supply was bid than required. Twenty-five bidders participated, and the total energy supply offered through those bids was approximately five times the energy Delmarva sought. Contracts were awarded to 14 of those bidders. In that process the resulting prices are expressly "market-based." Also, prices for supply obtained from the PJM spot markets are transparent and market-based. Delmarva would recommend that in either case these prices be directly incorporated into retail rates, thereby establishing directly a market basis for the supply component of the retail generation rates. Delmarva recommends that the settlements with wholesale providers include all transmission and distribution losses as well as the proportional share of unaccounted-for energy attributable to POLR load in settlement. Payments would be based on retail delivery amounts, and therefore the costs associated with losses would be implicit in the payments to suppliers for energy.

(ii) The second component of retail price would be the additional administration and transaction costs of procuring the wholesale supply, and the incremental costs of administration for POLR service attributable to the method of supply. For example, the costs of modifying accounting and settlement systems and to operate the revised systems would be incremental costs for which Delmarva should be compensated in retail rates on a contemporaneous basis. To achieve contemporaneous reimbursement, Delmarva would propose using estimated costs initially, and truing these costs up to actual incurred costs at appropriate intervals.

(iii) In addition, as provided in the statute, Delmarva should receive a reasonable margin to compensate shareholders for providing the service and accepting associated business risks. Presumably competitive service providers include a margin in the prices at which they offer to provide service. In Maryland, as a result of negotiations with stakeholders, Delmarva's rates include a return of two mils per kilowatt hour for small and intermediate size commercial customers and three mils per kilowatt hour for large commercial and industrial customers. Our hourly priced non-residential service rates include a return component of 2.25 mils per kilowatt hour.

5. *How will the Commission be assured that:*

a. an incumbent utility purchases electric energy from the market without adversely affecting itself or retail customers?

b. an incumbent utility purchases electric energy to assure minimum cost for such energy?

c. an incumbent utility uses appropriate hedging techniques in the purchase of electric energy? Should the cost of any hedging techniques be included among the "actual expenses" of electric energy?

RESPONSE:

5. a. Delmarva recommends in the case of procurement using an RFP that it prepare and present a plan to the Commission for review and approval prior to actual procurement activities. The plan would include the RFP, the bid evaluation process, and the full

requirements service agreement to be executed with successful bidders. In this way the Commission can directly influence the procurement practices, and therefore be satisfied that it has achieved a market-based result. The Commission can also reserve to itself a post-bid verification that the market-based procurement process has been followed. In this event, the Commission may want to consider employing an independent consultant to monitor the Delmarva procurement process and advise the Commission regarding the integrity of the process. Should Delmarva purchase from PJM spot markets, the Commission may rely on the PJM market monitoring function to assure itself that Delmarva and its customers are achieving fair, market-based results.

b. The use of a competitive RFP process should attract sufficient supplier interest to assure cost competition. By using price alone as the basis of awarding contracts, the Commission can be assured of the lowest available price being obtained. The PJM spot markets are based on price competition among suppliers, and are settled at the lowest available price. As noted above, 25 bidders participated in the Maryland process.

c. The RFP method recommended by Delmarva is itself a hedging mechanism. The contract(s) awarded to suppliers could fully supply Delmarva's load without additional purchases. Hedging risks would be assumed by the suppliers and the associated costs would presumptively be included in their bids. Purchases from spot markets could be used when economical for relatively small volumes over shorter periods. Of course, spot purchases are unhedged on price, although PJM itself guarantees delivery. If loads are large or over longer terms, Delmarva recommends obtaining the hedge through the RFP procurement process. All costs associated with procurement would be included in the retail price as discussed above.

6. Given the requirement that the methodology to determine "market-based costs" must be consistent with the goal of promoting economic development within the

Commonwealth, as well as promoting effective competition, should issues associated with the level and stability of rates and prices reflecting 'market-based costs' be considered? If so, how?

RESPONSE:

6. Rates that accurately reflect market costs should not distort local competition or economic development. Retail customers in general desire both stable and reasonable prices. There are some customers, such as Delmarva's peninsula customers in Virginia, who are relatively small consumers and for whom alternative providers may not offer competitive rates. These customers should be assured of service from Delmarva at rates that reflect market economies but are not subject to the volatility of wholesale markets. Therefore, Delmarva would recommend a procurement practice that combines short term purchases with longer term purchases in the general manner of dollar-cost averaging. The use of shorter term contracts – typically one-year contracts – would assure market sensitivity, but combined with two and three year contracts would add stability to rates. By procuring for some combination of one-two-and three-year contracts annually, both stability and market-based sensitivity can be achieved.

7. Should the ultimate methodology to determine "market-based costs" be permitted to vary among incumbent utilities? Explain why or why not.

RESPONSE:

7. Delmarva serves a relatively modest portion of the Commonwealth's retail electricity customers. While its recommended methods for procuring and pricing retail service are suitable for its territory, and can be efficiently and cost-effectively applied due to similarities within its other service territories, Delmarva would not necessarily recommend universal application. There may be economies and other benefits to customers from other techniques applied in other companies' service areas, depending on, among other parameters, the existence

of local generation, the liquidity and transparency of associated wholesale markets, and the interest in providing competitive services by alternative providers.

Respectfully submitted,

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